# In the Supreme Court of the United States

OCTOBER TERM, 1963

No. ——

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

ESTATE OF ANNETTE S. MORGAN, DECEASED,
WILLIAM H. MORGAN, EXECUTOR

## CONDITIONAL PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in this case on April 10, 1963, but only in the event that a writ of certiorari is granted in *Sheaffer* v. *Commissioner*, No. 183, this Term.

### OPINIONS BELOW

The opinion of the Tax Court (R. 52a–60a)[1] is reprinted in full in Appendix E (pp. 31a–38a) of the petition for certiorari in *Sheaffer* v. *Commissioner*, No. 183, upon the granting of which this petition is conditioned. We have accordingly considered it unnecessary to reprint the opinion in this petition.

[1] "R." refers to the appendix to the government's brief in the court of appeals.



698-750—63

ported at 37 T.C. 981. The *per curiam* order of the court of appeals (Appendix, *infra*, p. 5) is reported at 316 F. 2d 238.

## QUESTION PRESENTED

Whether the grantor is taxable, under § 677 of the Internal Revenue Code of 1954, on the income of a trust used to repay amounts borrowed by the trust in a prior year to pay the grantor's gift taxes on the transfer to the trust.

## STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set forth in the government's brief in opposition in *Sheaffer* v. *Commissioner*, No. 183, this Term.

## STATEMENT

On October 18, 1955, Annette S. Morgan transferred approximately $1 million worth of stock in trust for the benefit of her issue (R. 53a). During the term of the trust, the trustees were given discretion to distribute income (and, if necessary, principal) to or for the benefit of the issue, with any undistributed income to be added to principal at the end of each year. Upon termination of the trust, the principal and accumulated income were to be distributed among the issue then living as prescribed in the trust instrument (R. 12a–21a).

The trust agreement provided (R. 10a):

> The parties hereto expressly agree that the trustees shall pay any and all gift and/or other taxes occasioned by the transfer herein, and

> that the stock is transferred subject to the trustee's obligation to pay all such taxes. The trustees shall make all necessary arrangements for and attend to the payment of all said taxes, and may raise funds for such purpose by selling a portion of the transferred stock and/or by borrowing, the decision to sell stock and/or to borrow to be made in accordance with the sole discretion of the trustees. In the event the trustees decide to borrow money to pay said taxes, they are hereby authorized to borrow money from any source and pledge any part or all of the assets herein transferred, and to repay such borrowings using for such purpose any funds in their possession.

The gift tax due, computed on the net value of the gift after deducting the trustee's assumed obligation to pay the gift tax, was $186,665. On the due date for the grantor's 1955 gift tax return, April 16, 1956 (April 15 having been a Sunday), the trustees paid the tax. The funds to pay the tax were borrowed from a bank on a note signed by the trustees and secured by a pledge of the stock (R. 7a, 55a).

In 1957 and 1958, the trustees, using dividends received on the trust's stock, repaid $21,665 and $40,000, respectively, of the principal of the note (R. 55a). The Commissioner held that the trust income so applied to satisfy an obligation incurred for the payment of the grantor's gift tax liability was taxable to the grantor under § 677 of the Internal Revenue Code of 1954.[2] The Tax Court, in a decision reviewed by

[2] The interest payments made to the bank were also held to be taxable to the grantor, but their inclusion in her income was offset by a compensating interest deduction (R. 3a, 5a).

the full court with Judges Tietjens, Turner and Raum dissenting, set aside the deficiency determination, holding that, since the grantor's gift tax liability was fully satisfied in 1956, she had no remaining interest in the trust in 1957 and 1958 and received no benefit from the application of the income of those years (R. 52a–60a). The court of appeals affirmed *per curiam* on the opinion of the Tax Court.

## REASONS FOR GRANTING THE WRIT

The pending petition for certiorari in *Sheaffer* v. *Commissioner*, No. 183, this Term, asserts that the decision of the Eighth Circuit in that case is in conflict with the decision of the Sixth Circuit in this case. For the reasons stated in our brief in opposition in the *Sheaffer* case, it is our contention that the decisions are not in conflict and that certiorari should be denied. The sole reason for this petition is to protect the government's interests should the petition in *Sheaffer* nevertheless be granted.

## CONCLUSION

If the petition for certiorari in *Sheaffer* v. *Commissioner*, No. 183, is granted, the petition in this case should also be granted. Otherwise, it should be denied.

Respectfully submitted.

ARCHIBALD COX,
*Solicitor General.*

JULY 1963.

# APPENDIX

NO. 15099

## United States Court of Appeals for the Sixth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

ESTATE OF ANNETTE S. MORGAN, DECEASED, WILLIAM H. MORGAN, EXECUTOR, RESPONDENT.

ORDER FILED APRIL 10, 1963—CARL W. REUSS, CLERK

Before: McALLISTER and O'SULLIVAN, *Circuit Judges*, and WILLIAM E. MILLER, *District Judge*.

This cause coming on to be heard upon the petition for review of the decision of the Tax Court of the United States, and the court having considered the briefs, oral argument of counsel, and the entire record,

Now, therefore, it is ORDERED, ADJUDGED and DECREED that the decision of the Tax Court be and is hereby affirmed on its Findings of Fact and Opinion, reported at 37 T.C. 981.

APPROVED FOR ENTRY:

/s/ WILLIAM E. MILLER
*United States District Judge*
*Sitting by Designation*



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# BRIEF FOR THE RESPONDENT IN OPPOSITION

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# In the Supreme Court of the United States

**OCTOBER TERM, 1963.**

**No. 262.**

COMMISSIONER OF INTERNAL REVENUE,

*Petitioner,*

*v.*

ESTATE OF ANNETTE S. MORGAN, DECEASED,
WILLIAM H. MORGAN, EXECUTOR,

*Respondent.*

ON CONDITIONAL PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS,
FOR THE SIXTH CIRCUIT.

## BRIEF FOR THE RESPONDENT
**In Opposition to Conditional Petition for Certiorari.**

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ON CONDITIONAL PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS,
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## BRIEF FOR THE RESPONDENT
### In Opposition to Conditional Petition for Certiorari.

## QUESTION PRESENTED.

Where a grantor in 1955 created irrevocable trusts, retaining no interest therein save that the trusts were to pay the gift tax resulting from the transfers, and the trustees were authorized in their sole discretion to sell trust assets or to borrow to obtain funds to pay such gift tax, and in 1956 the trustees borrowed from a bank and used the loan proceeds to pay the gift tax, the grantor having absolutely no liability for or connection with such loan, did the Tax Court and the Court of Appeals for the Sixth Circuit correctly determine that the 1957 and 1958 trust income applied in repayment of such loan did not constitute income taxable to the grantor in 1957 and 1958 under Section 677 of the Internal Revenue Code of 1954?

## STATEMENT.

The statement in the Conditional Petition for Writ of Certiorari is insufficient in the following respects (in all other respects such Statement being acceptable to respondent):

1. The property transferred by the grantor to the irrevocable trusts in 1955 consisted of 41,600 shares of common stock in The Morgan Engineering Company (R.[1] 6a, 53a). This company had approximately 189,000 common shares outstanding and approximately 1,200 common stockholders (Resp. Br.[2] 1b, 2b). The Morgan stock in 1955 was, and at all times since that date continued to be actively traded in the over-the-counter market (R. 6a).

2. The decision to obtain money to pay the gift tax in 1956 by borrowing, rather than by selling stock, was made by the trustees and the decedent took no part in such decision (R. 55a). The grantor had no contact with the bank in connection with the loan and was not liable for its payment (R. 55a). The grantor received no benefit from the fact that the money to pay the gift tax was obtained by borrowing rather than by selling a part of the trust corpus (R. 56a).

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[1] "R" refers to the government's brief in the Court of Appeals.

[2] "Resp. Br." refers to respondent's brief in the Court of Appeals.

## REASONS WHY A WRIT OF CERTIORARI SHOULD NOT BE GRANTED IN THIS CASE.

### A. THE COURTS OF APPEAL ARE NOT IN CONFLICT ON THE MORGAN ISSUE.

There is no conflict between the decision of the Court of Appeals for the Sixth Circuit in this case and the decision of the Court of Appeals for the Eighth Circuit in *Sheaffer v. Commissioner*, No. 183, this Term. Accordingly there is no basis for granting a Writ of Certiorari.

**1. In Morgan the gift tax had been fully discharged in a prior year; the taxable years in question were years when the trustees had no obligation to the grantor and made no payment for the benefit of the grantor. In Sheaffer, on the other hand, the taxable years in question were years when the trustee did have an obligation to pay the gift tax and did pay the gift tax.**

This "different year" aspect of these cases is the essential and controlling distinction between *Morgan* and *Sheaffer*. In *Morgan*, the grantor's gift tax obligation was fully satisfied in 1956. After 1956, Mrs. Morgan, the grantor, had no liability either for the gift tax or for the loan obtained by the trustees.

The taxable years involved in *Morgan* are 1957 and 1958, when no benefit was received by the grantor. In 1957 and 1958 the Morgan trustees applied current trust income to the repayment of the loan which they had obtained (in *Morgan* the trustees had only $12,480 of income in each of the years 1955 and 1956 (R. 4)).

*Sheaffer*, on the other hand, involved the years 1954 and 1955, 1955 being the year when the gift tax was paid. In *Sheaffer*, 1954 income of $140,000 was accumulated to be applied on the gift tax. In 1955 the trustee had $115,500 of income, and in 1955 the trustee paid gift taxes of $327,

307.04, which exceeded the aggregate of all of the 1954 and 1955 income.

Thus, in *Morgan* the issue was whether in 1957 and 1958, when the trustees owed nothing to the grantor and the grantor received no benefit, the grantor was taxable on trust income applied in reduction of the trustees' obligation to the bank. In *Sheaffer*, the issue was whether the 1954 income which was accumulated to pay the gift tax was taxable to the grantor and whether the income of the year 1955 when the gift tax was paid was likewise taxable to the grantor.

In *Sheaffer*, the principal issue was whether payment of the gift tax in 1955 resulted in satisfaction of an obligation of the grantor. In *Morgan* the income in question was for later years when there was no obligation of the grantor to be satisfied, and no question was presented as to whether or not payment of the gift tax resulted in satisfaction of an obligation of the grantor. Thus, the critical facts and the issues in the two cases are entirely different.

**2. The tax treatment in Sheaffer of the $66,892.96 of income received during the year of the gift tax payment (1955), but after March 14 of that year, does not conflict with the tax treatment in Morgan of the income of years later than the year of the gift tax payment.**

This second distinction is in a sense a variation of the first, but it warrants statement separately.

The Government in its conditional petition in this case states that the taxpayer's petition in *Sheaffer* asserts a conflict between that case and this one. The Government correctly states that there is no conflict and has stated its reasons in its opposition brief in *Sheaffer*. From the Government's opposition brief in *Sheaffer* it appears that the taxpayer in *Sheaffer* is arguing that there is a con-

flict between the tax treatment accorded in *Morgan* to the income realized by the trusts in 1957 and 1958, and applied on their bank loan in those years, which were not the years when the gift tax was paid, and the tax treatment accorded in *Sheaffer* to the $66,892.96 of income received by the *Sheaffer* trusts between March 14, 1955, and December 31, 1955, and applied on the bank loan in that year, which was the year when the gift tax was paid.

Because of the "different year" distinction mentioned above, there is no conflict. In *Sheaffer* the 1955 income in question was all realized during the year in which the gift tax was paid. Accordingly, once it was concluded that the payment of the gift tax was a payment for the benefit of the grantor, the grantor must be considered under Section 677 to be the owner of the trust for the entire year, and not for only that portion of the year up to the time of payment of the gift tax. In *Morgan*, on the other hand, the income in question was for years subsequent to the year in which the gift tax was paid.

It is too well established to require citation of authority that under our income tax law, liability for income tax is determined on an annual basis. Thus, if a trust on March 14 makes a payment for the benefit of the grantor, using the entire trust income accumulated to that date, plus some principal (irrespective of whether the principal be obtained by selling securities or by borrowing), the grantor is treated as owner of the trust and is taxable with the income of the trust for the entire year, under Section 677, at least to the extent that the income for the entire year does not exceed the amount of the benefit received by the grantor on March 14. That is the *Shaeffer* case. Indeed, if the grantor were not so taxable under Section 677, she would be taxable under Section 662. See Regulations Section 1.662(a)-4.

In *Sheaffer* the grantor was taxable on 1955 income, for the reason that her gift tax was paid by the trustee in 1955. She was taxable on 1955 income, irrespective of whether that income was received before or after March 14, and irrespective of whether some of that income was used to repay the bank loan.

In *Morgan* the 1957 and 1958 income in question was income of years when nothing was paid to or for the benefit of the grantor, and for that reason the 1957 and 1958 income was not taxable to the grantor.

The Commissioner, in his brief in opposition in *Sheaffer* at page 8, implies that the argument which "carried the day" for the taxpayer in *Morgan* was that "the after-received income used to repay the loan should be treated differently from the accumulated income used to pay the gift tax itself." This is not an accurate statement of the taxpayer's position.

The taxpayer's position in *Morgan*, which was properly sustained by the Tax Court and the Court of Appeals for the Sixth Circuit, is that the income in question was not only "after-received" income—it was "later-year" income. The only benefit received by the grantor in *Morgan* was received by her in 1956. No benefit was received by her in the later years, and therefore income of the later years was not taxable to her under Section 677.

In *Morgan* the evidence established and the Tax Court noted that the grantor's interest in the trusts terminated immediately upon the payment of the gift tax in 1956. The Tax Court decision in *Morgan* cannot be taken as meaning or implying, however, that income received during 1956 but after the gift tax was paid would not be taxable to the grantor.

In *Morgan* neither the Tax Court nor the Court of Appeals asserted that income received in the year of the

gift tax payment is not taxable to the grantor. There was no 1956 income involved in *Morgan*. Thus, it made no difference to the decision in *Morgan* whether the gift tax was paid on April 16, 1956 or on December 31, 1956. What the courts below held was that the grantor's interest in the trust terminated in 1956 and therefore she was not taxable on the 1957 and 1958 "later years" income of the trusts. Obviously, therefore, *Morgan* does not conflict with *Sheaffer*, where it was held that income of the year when the gift tax was paid was taxable to the grantor. The *Sheaffer* issue was not involved in *Morgan*, and the *Morgan* issue was not involved in *Sheaffer*.

It is true that in *Morgan* certain income which (i) was received after the gift tax was paid and (ii) was applied on the bank loan, was held not taxable to the grantor; whereas in *Sheaffer* certain income which (i) was received after the gift tax was paid and (ii) was applied on the bank loan, was held to be taxable to the grantor. Superficially it might appear from those facts that the cases conflict. But upon analysis it becomes clear that there is no conflict at all.

Let us take first the common fact that both cases involved income received after the day when the gift tax was paid. In *Morgan* the grantor prevailed not because the income in question was received after the day the gift tax was paid but because it was received after the year when the gift tax was paid. In *Sheaffer*, on the other hand, the income in question was income of the year when the gift tax was paid, and the grantor was taxed on that income. Thus, there is no conflict in the common fact of after-received income: *Morgan* was "later-year" income, whereas *Sheaffer* was "same-year" income.

Let us turn now to the common fact that both cases involved income applied by the trustees in payment of

a bank loan. This fact does not indicate a conflict because it was not material to the decision in either case.

In *Morgan* some of the 1957 and 1958 income was applied on the bank loan; some was not so applied. It was held that none of the income was taxable to the grantor because the grantor received no benefit from the trusts in those years.

In *Sheaffer*, in 1955, when the gift tax was paid, $66,892.96 of income was received after March 15, 1955 and was applied on the bank loan. That income was held taxable to the grantor because it was income of the year 1955 when the gift tax was paid. It would have been held taxable to the grantor even though it had not been used to repay the loan; the fact that the $66,892.96 was used to repay the loan did not affect the result in *Sheaffer*. Conversely, the fact that $66,892.96 was used to repay the loan could not save the grantor from taxability in *Sheaffer*. The loan repayment factor is an irrelevancy.

The critical facts are that *Morgan* is a "later-year" case, whereas Sheaffer is a "gift-tax-payment-year" case; the two cases are distinguishable in this critical respect, and there is no conflict.

**B. EVEN IF THERE WERE A CONFLICT, THE COURT OF APPEALS IN THIS CASE WAS CORRECT IN ITS AFFIRMANCE OF THE TAX COURT DECISION THAT APPLICATION OF 1957 AND 1958 INCOME TO PAY THE TRUSTS' BANK LOAN DID NOT CONSTITUTE INCOME TAXABLE TO THE GRANTOR.**

It will be noted that the government does not take issue with the decisions below in this case, on their merits. The government's position is that certiorari should be denied here unless certiorari is granted in *Sheaffer*. We respectfully submit that certiorari should be denied in this case in any event.

In 1956, the Morgan trustees decided to obtain money to pay the grantor's 1956 gift tax obligation by borrowing rather than by selling stock. This decision was solely the decision of the trustees, and was based upon investment considerations. The grantor had absolutely no part in making that decision. When the trustees borrowed the grantor took no part in any of the negotiations preceding the making of the loan nor was she liable in any way for the payment of the loan. The above facts were found by the trial court and the record clearly substantiates the court's finding. In 1957 and 1958, the taxable years in question, the grantor had no further obligation respecting the gift tax, she had no obligation on the payment of the bank loan, and she had no continu ig interest in the trusts. It must follow that in those years none of the income of the trusts was distributed to her either directly or constructively. Both the Tax Court and the Court of Appeals for the Sixth Circuit so held, and all of the available authorities support this decision.

In *Morgan* the trustees had the responsibility and authority to determine whether to sell stock or to borrow to pay the 1956 gift tax. They decided, as an investment matter, to borrow rather than to sell stock. Had they, instead,

sold stock, using the proceeds to pay the 1956 gift tax, and then used 1957 and 1958 trust income to replace the stock so sold, such 1957 and 1958 trust income would not be taxable to the grantor, even though the grantor had directed the trustees to use trust income to replace the stock sold. It was so held in *Keith v. Commissioner*, 45 B. T. A. 644 (1941), acq. 1942-1 Cum. Bull. 10, a decision acquiesced in by the Commissioner. *Keith* is direct authority for the conclusion reached by the lower courts in *Morgan*: that trust income for years *subsequent* to the year in which grantor's obligation is discharged, cannot be taxed to the grantor.

Even as *Keith* supports the decisions of the lower courts in *Morgan*, so also do the Treasury Regulations themselves. Thus, Section 1.677(a)-1(c) of the Income Tax Regulations provides:

> * * * *If the grantor strips himself permanently and definitely of every interest described in the first sentence of this paragraph, he is not treated as an owner under Section 677 after that divesting* * * *.
> (Emphasis Supplied.)

In the *Morgan* case, the grantor's gift tax obligation was fully satisfied in 1956 when the gift tax was paid. After the payment of the gift tax, the grantor had no further liability or obligation of any kind, and she had no further interest in the trusts. She had stripped herself "permanently and definitely of every interest" in the trusts. The conclusion which the Commissioner reaches in this situation, in his own Regulations, is that the grantor is not to be treated as an owner after that divesting.

There can be no question about the Commissioner's own views on the problem here presented. Any question is dispelled by the Commissioner's own Revenue Ruling 54-516, 54-2 Cum. Bull. 54, applying Section 167 of the

1939 Code (the antecedent of the Section 677 of the 1954 Code here involved). Indeed, the fact that the Commissioner is not seeking certiorari here except conditionally, indicates that the Commissioner still adheres to Revenue Ruling 54-516. Revenue Ruling 54-516 squarely supports the decision of the Tax Court in the *Morgan* case and the subsequent affirmance of that decision by the Court of Appeals. Revenue Ruling 54-516 dealt with a transfer in trust of real estate which was subject to a mortgage. The question considered was whether the grantor of the trust was taxable with trust income used to pay the mortgage indebtedness. The Commissioner expressly ruled that if the grantor did not remain personally liable on the mortgage then trust income paid on the mortgage would not be taxable to the grantor.

In *Morgan*, had the grantor borrowed to pay the gift tax herself, and then transferred the stock subject to her loan, trust income for subsequent years, used to repay the loan, would not have been taxed to her had she not remained liable on the loan. This is Revenue Ruling 54-516. In *Morgan*, however, there is no question about whether the grantor's liability on the loan continued or was cut off, because the grantor was never liable on the loan. Thus, the Commissioner's own interpretation of the statute as set forth in Revenue Ruling 54-516 compels the conclusion that the 1957 and 1958 trust income used to discharge the trusts' obligation was not income to the grantor.

## CONCLUSION.

Respondent contends that this case raises no issue calling for the granting of a Writ of Certiorari. Respondent urges that the Court of Appeals correctly affirmed the decision of the Tax Court that the trustees' payments in 1957 and 1958 of their bank loan did not constitute income to the grantor.

Respondent submits that the Court of Appeals affirmance of the Tax Court decision in the *Morgan* case presents no conflict with any decision of this Court or with any decision of another court of appeals or with any district court or administrative decision and it presents no issue of law for which this Court should grant the petition for a writ of certiorari.

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